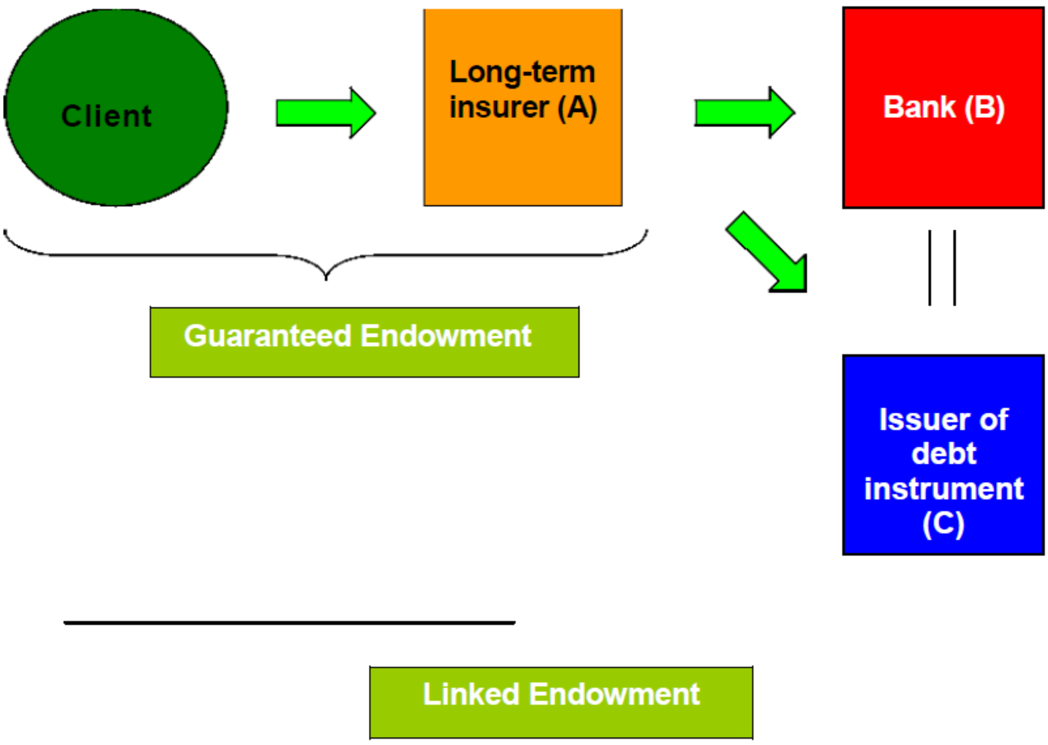
Guaranteed vs. Linked Endowments

Conservative investors often take comfort in capital guaranteed products, like fixed deposits, money market funds, retail bonds or guaranteed endowments. All these products guarantee the security of capital, and with fixed deposits, retail bonds and guaranteed endowments, the interest on capital is also guaranteed if held to maturity.

Linked endowments

Linked endowments are more recent additions to the secured rates market. These endowments stipulate that the quoted maturity value is not guaranteed by the issuing insurer, but rather by the underlying instruments held by the insurer. The insurer under a linked endowment therefore *introduces additional counterparty risk* to a potential investor.
This means that there are *two or three counterparty risks* present in the linked endowment structure. The following diagram illustrates this point:



For guaranteed endowment, the client's exposure is limited to the long-term insurer (A).
For a linked endowment, the client is exposed to the default risk of the insurer (A), the bank sourcing the debt instruments that back the maturity value (B), and the issuer of the debt instruments (C). The insurer may also source the underlying debt instruments directly, which then eliminates the default risk from the bank (B).

The ability for each of these parties to hold up their end of the bargain is therefore of critical importance.

Credit ratings

The following table illustrates the varying levels of security, as measured by the credit ratings (CR) from Fitch (National Long-term Rating as at July 2013), being offered by some of the more prominent linked and guaranteed endowments in the market:

Endowment	Insurer	CR	Bank	CR	Debt	CR
Guaranteed	Old Mutual	AAA				
Guaranteed	Sanlam	AA				
Guaranteed	Discovery	AA+				
Guaranteed	MMI	AA+				
Guaranteed	Liberty	AA -				
Guaranteed	Hollard Life	AA				
Guaranteed	Clientèle Life	AA	Various banks	A+	Financial instruments	A+
Linked	Nedgroup Life	AA-	Nedbank	AA	Financial instruments	AA
Linked	ABSA Life	AAA	ABSA	AAA	Various banks	A

N/A – Not available N/D – Not disclosed

* Subsidiary life companies are used to underwrite the guarantee.

So how does a credit rating of A compare to a rating of AAA?
Well, the market expects A rated debt to offer a premium of 1% to 1.5% on the interest rate offered by a AAA rated debt instrument, to compensate for the additional default risk. So if the safest debt (AAA rated) offers a return of 10%, then A-rated debt should offer a return of 11% to 11.5%.

Assessing guarantees

The following steps are very important when deciding on a low-risk investment provider:

1. Is the product a guaranteed OR linked endowment?
2. For a guaranteed endowment, who is the insurer, and what is its financial strength?
3. For linked endowments, who are the counterparties to the transaction and are you comfortable about their financial strength?
4. What are the credit ratings of the counter parties?
5. Is the interest rate premium being offered sufficient for the additional counterparty risk?
6. Are you comfortable with accepting the additional counterparty risk?